

**Office of Chief Counsel
Internal Revenue Service**

memorandum

CC:SB:8:LN:2:GL-122919-01
WBDouglass

date: SEP 17 2001

to: Appeals Office, Riverside, Area 10, Group 10
Attention: Ms. Lynn Lipscomb, Appeals Officer

from: WILLIS B. DOUGLASS
Attorney (SBSE)

subject: **Advisory Opinion on What Type of Determination to Issue**
Taxpayer: [REDACTED] **EIN** [REDACTED]

This memorandum responds to your request for assistance dated May 11, 2001. This memorandum should not be cited as precedent.

ISSUES

1. Was it proper for the IRS to have issued a notice of determination under I.R.C. § 7436 that reclassified workers who performed services for [REDACTED] ("[REDACTED]"), as employees of [REDACTED] when some of those workers were treated as employees of a leasing company?

2. Was the issuance of the notice of determination under I.R.C. § 7436 a procedural error that must be noted in the Collection Due Process notice of determination?

3. Should Appeals consider the underlying tax liability in this Collection Due Process case, or is the taxpayer precluded from raising this issue because the taxpayer received the notice of determination under I.R.C. § 7436?

4. Which type of Collection Due Process notice of determination should be issued in this case: a Letter 3193 which directs the taxpayer, if it wishes to challenge Appeals' determination, to file its petition in the Tax Court, or a Letter 3194 which directs the taxpayer to file a petition with the appropriate district court?

CONCLUSIONS

1. The notice of determination under I.R.C. § 7436 was properly issued.

2. The issuance of the notice of determination under I.R.C. § 7436 was not a procedural error and need not be noted as such on the Collection Due Process notice of determination.

3. Appeals should not consider the merits of the taxpayer's contention that it does not owe the employment tax liability at issue in this case; however, Appeals should consider the merits of the taxpayer's contention that it is entitled to an abatement of interest and penalties.

4. The Collection Due Process notice of determination in this case should be issued on Letter 3193 and not on Letter 3194.

FACTS

██████████, the taxpayer, is now out of business. During ██████████, the year at issue, the taxpayer owned and operated a retail ██████████ store. The taxpayer employed cashiers, sales and stock clerks and clerical help. Prior to ██████████, the taxpayer had always treated the above workers as its own employees. During ██████████, the taxpayer entered into a contract with ██████████ ("██████████"), whereby the taxpayer and ██████████ agreed that the taxpayer's former employees would henceforth be employees of ██████████ which would then lease the employees back to the taxpayer. The taxpayer's managers were included in this leasing arrangement.

The agreement between the taxpayer and ██████████ provided that the taxpayer would provide ██████████ with all payroll information no later than three days prior to the taxpayer's payroll due date. This was necessary so that ██████████ could invoice the taxpayer for the amount due within two days of the payroll due date. ██████████ would pay the employees after receiving payment from the taxpayer. The taxpayer would write one check to ██████████ per payroll period to cover gross pay, taxes, service fee and workman's compensation. The taxpayer has stated that in practice a representative of ██████████ hand-delivered the payroll checks and picked up payment from the taxpayer at the same time.

According to the agreement between the taxpayer and ██████████, if the taxpayer did not pay ██████████ by the payroll due date, the employees would "revert to sole employees" of the taxpayer, and the taxpayer would be responsible for the wages, taxes, and other payments which ██████████ had contracted to pay. The file indicates that the taxpayer paid ██████████ on time for each pay period during the first three quarters of ██████████.

██████████ never exercised any type of control over the employees. They continued to report to the taxpayer's managers, just as they

had before the taxpayer entered into its leasing agreement with [REDACTED].

At the end of [REDACTED], the taxpayer withdrew from its contract with [REDACTED]. At some point between the end of [REDACTED] and [REDACTED], [REDACTED] ceased doing business. [REDACTED] filed Form 941 employment tax returns with the IRS under its own name as employer of the leased employees for the first three quarters of [REDACTED]. However, only a small part of the taxes due for these three quarters was actually paid. The taxpayer filed its own Form 941 for the fourth quarter of [REDACTED].

During [REDACTED], the taxpayer made payments totaling \$[REDACTED] for which the taxpayer did not file Forms 1099 or Forms W-2. Some of these payments were made to the taxpayer's leased employees, but the majority were paid to individuals not included in the [REDACTED] leasing agreement.

In [REDACTED] the IRS opened an examination of all four quarters of the taxpayer's [REDACTED] employment taxes. As a result of this examination, the IRS determined that the leased workers were employees of the taxpayer and not employees of [REDACTED]. During the examination the taxpayer provided very little evidence about the individuals who received the payments totaling \$[REDACTED]. However, certain third parties told the revenue officer examiner ("ROE") that some of these individuals were part-time sales people and cashiers, and some were "[REDACTED] employees." Both of these groups apparently worked at [REDACTED] shows for the taxpayer on the side. The ROE reclassified all of these individuals as employees of the taxpayer.

The taxpayer did not agree with the position taken by the IRS in the examination. Therefore, a *Notice of Determination Concerning Worker Classification under Section 7436* ("§ 7436 Notice") was issued to the taxpayer on [REDACTED]. The taxpayer defaulted on the § 7436 Notice, and the amounts shown thereon were assessed on [REDACTED].

In an attempt to collect this liability, the IRS, on or about [REDACTED], filed with the Office of the Secretary of State of California a notice of federal tax lien ("NFTL") against the taxpayer. The NFTL sets forth the following liabilities:

<u>Tax Period</u>	<u>Type of Tax</u>	<u>Unpaid Liability</u>
First Quarter [REDACTED]	Form 941	\$ [REDACTED]
Second Quarter [REDACTED]	Form 941	\$ [REDACTED]
Third Quarter [REDACTED]	Form 941	\$ [REDACTED]
Fourth Quarter [REDACTED]	Form 941	\$ [REDACTED]
[REDACTED] FUTA	Form 940	\$ [REDACTED]
Total:		\$ [REDACTED]

On [REDACTED], the IRS sent to the taxpayer a Letter 3172, *Notice of Federal Tax Lien Filing and Your Right to a Hearing under I.R.C. § 6320*. In response, the taxpayer requested a collection due process ("CDP") hearing under I.R.C. § 6320. In the CDP request, the taxpayer stated at follows: "Payroll leasing company we hired in good faith filed only payroll returns, but did not pay taxes due with returns that we paid them to file and pay." The taxpayer attached a Form 843, *Claim for Refund and Request for Abatement* to its CDP request. The Form 843 requests that all interest and penalties be abated "due to reasonable cause." The taxpayer also stated on the Form 843, "Total tax (employment due) is \$ [REDACTED]. Abatement request for reasonable cause due to fact we paid leasing payroll company ([REDACTED]) and they did not forward or pay taxes to IRS for us."

You have informed us that you are now ready to issue a notice of determination in this CDP case, and you have asked us to address the issues set forth above before the notice of determination is issued.

ANALYSIS

In your transmittal you stated that you accept the determination by the ROE that under the Internal Revenue Code and under applicable common-law rules, the leased employees discussed above were actually employees of the taxpayer and not employees of [REDACTED]. Since you have not asked us to review this issue, and since we see nothing in the file to indicate that ROE's determination is incorrect, we will not include a detailed discussion of this issue. If we have misunderstood your request, please so inform us, and we will revise this opinion.

You have also stated that you accept the ROE's determination that the individuals who received unreported payments from the taxpayer were employees of the taxpayer. You have stated that you

agree that it was proper to reclassify these workers on the § 7436 Notice. As is more fully discussed below, we conclude that the issuance of the § 7436 Notice was proper for all of the workers. Therefore, we will not include in this memorandum any further separate discussion of these "non-leased" individuals.

A. The Scope of I.R.C. § 7436

Although the Tax Court generally does not have jurisdiction over employment tax issues, there is an exception for worker classification issues under I.R.C. § 7436:

Creation of Remedy.--If, in connection with an audit of any person, there is an actual controversy involving a determination by the Secretary as part of an examination that--

(1) one or more individuals performing services for such person are employees of such person for purposes of subtitle C, or

(2) such person is not entitled to the treatment under subsection (a) of section 530 of the Revenue Act of 1978 with respect to such an individual,

upon the filing of an appropriate pleading, the Tax Court may determine whether such a determination by the Secretary is correct **and the proper amount of employment tax under such determination.** [Emphasis added.] Any such redetermination by the Tax Court shall have the force and effect of a decision of the Tax Court and shall be reviewable as such.

I.R.C. § 7436(a).

The phrase "and the proper amount of employment tax under such determination" was not in the original version of I.R.C. § 7436(a) as enacted by the Taxpayer Relief Act of 1997, P.L. 105-34. The Tax Court decided under the statute as originally enacted that it had jurisdiction under I.R.C. § 7436 only over the classification issue. The court decided that it did not have jurisdiction over the amount of employment tax that resulted from reclassification of the workers. Henry Randolph Consulting v. Commissioner, 112 T.C. 1 (1999).

In response to Henry Randolph Consulting, Congress included a technical correction to I.R.C. § 7436(a) in the Community Renewal Tax Relief Act of 2000, P.L. 106-554. This statute amended I.R.C.

§ 7436(a) by adding the language shown above in bold, thus overruling Henry Randolph Consulting. Since this amendment is a technical correction, it is effective as of August 5, 1997, the date of enactment of I.R.C. § 7436.

I.R.C. § 7436(b)(1) provides that only the person for whom the work was performed may be a petitioner under this section. The petition must be filed before the 91st day after the IRS mails a notice of determination to the alleged employer. I.R.C. § 7436(b)(2). The basic principles of the deficiency procedures of I.R.C. §§ 6213(a), (b), (c), (d) and (f); 6214(a); 6215 and 6503(a) apply to proceedings conducted under I.R.C. § 7436. I.R.C. § 7436(d)(1). For purposes of I.R.C. § 7436, the term *employment taxes* means any tax imposed by subtitle C of the Internal Revenue Code. I.R.C. § 7436(e).

B. Collection Due Process

If a taxpayer fails or refuses to pay a tax liability after notice and demand for payment, a lien arises in favor of the United States on all of the taxpayer's property and rights to property. I.R.C. § 6321. The lien of I.R.C. § 6321 is not valid as against purchasers, holders of a security interest, mechanic's lienors, or judgment lien creditors until an NFTL is filed. I.R.C. § 6323(a).

Effective for NFTLs filed on or after January 19, 1999, the IRS is required to provide a taxpayer with the opportunity to administratively appeal the filing of the NFTL by filing a formal request for a CDP hearing with the IRS Office of Appeals. I.R.C. § 6320. The IRS must notify a taxpayer within five business days after the NFTL is filed that the taxpayer may request a CDP hearing. The taxpayer has thirty days after the end of the five-day period in which to submit a request for a CDP hearing. I.R.C. § 6320(a)(3)(B). The request must be in writing and must include the reason or reasons why the taxpayer disagrees with the filing of the NFTL. Temp. Treas. Reg. § 301.6320-1T(c), Q&A-C2.

In general, the taxpayer may raise any relevant issue related to the unpaid tax at the CDP hearing. The taxpayer may assert innocent spouse status, challenge the appropriateness of the lien, request collection alternatives, such as an installment agreement or offer in compromise, and suggest which assets should be used to satisfy the tax liability. I.R.C. §§ 6320(c) and 6330(c)(2)(A). The existence or amount of the tax liability, however, may only be challenged if the taxpayer did not receive a timely statutory notice of deficiency or otherwise have the opportunity to dispute the tax liability. I.R.C. §§ 6320(c) and 6330(c)(2)(B).

The determination by Appeals in a CDP hearing is subject to judicial review if the taxpayer files a timely appeal. I.R.C. §§ 6320(c) and 6330(d). I.R.C. § 6330(d)(1) provides as follows:

The person may, within 30 days of a determination under this section, appeal such determination--

(A) to the Tax Court (and the Tax Court shall have jurisdiction with respect to such matter);
or

(B) if the Tax Court does not have jurisdiction of the underlying tax liability, to a district court of the United States.

If a court determines that the appeal was to an incorrect court, a person shall have 30 days after the court determination to file such appeal with the correct court.

C. The Validity of the § 7436 Notice

We have not located any case or other authority which addresses the issue of whether I.R.C. § 7436(a) applies only to controversies concerning the classification of workers as employees or independent contractors vis-a-vis the person who hired them. For example, in the present case, there is no issue as to whether or not the leased workers were employees; both the IRS and the taxpayer agree that the leased workers were employees. Rather, the issue is whether the leased workers were employees of the taxpayer or employees of [REDACTED]. The literal language of I.R.C. § 7436(a), quoted above, states that I.R.C. § 7436 applies if "in connection with an audit of any person, there is an actual controversy involving a determination by the Secretary as part of an examination that . . . individuals performing services for such person are employees of such person" Even though the present case does not involve an employee-vs.-independent-contractor issue with regard to the leased workers, we do have a controversy, arising out of an audit of the taxpayer by the IRS, concerning whether the leased workers were employees of the taxpayer. Therefore, we conclude that I.R.C. § 7436 does apply to the present case, and that the § 7436 Notice, discussed above, was properly issued to the taxpayer on [REDACTED].

D. Consideration of the Underlying Tax Liability in the CDP Case

Before we can determine whether Appeals has jurisdiction over the underlying tax liability in the CDP case, we must determine exactly what the taxpayer wishes Appeals to review. In your

proposed draft of the Appeals Case Memo for this case you stated as follows:

With respect to what portion of the liability [is] being challenged, the taxpayer's position at the time of the CDP request was filed is unclear. It appears that the revenue officer's explanation of the tax itself (after first securing the report and discussing it with the revenue agent) was accepted by the taxpayer prior to the lien filing, though the taxpayer and the revenue officer both considered it to be "unfair" On [REDACTED], after the notice of lien had been mailed but prior to the Form 12153 filing, ICS notes show that the revenue officer had a telephone conversation with the taxpayer which included a suggestion that the taxpayer write a letter requesting abatement of penalties for reasonable cause. The next taxpayer action was [REDACTED]'s signing of Form 12153 and faxing it to the revenue officer on [REDACTED]. It included this statement: "Payroll leasing company we hired in good faith filed only payroll returns, but did not pay taxes due with returns that we paid them to file and pay." Two days later it was also mailed, accompanied by a Form 843 signed by [an officer of the taxpayer]. The Form 843 specifically referred to interest and penalties, but it's not clear from the explanation whether it was also intended to include the underlying employment tax. The Form 12153 by itself seems to indicate a challenge to the underlying tax, but when read in conjunction with the Form 843 the taxpayer's statements could be interpreted as referring only to penalties and interest. Because it isn't clear, the entire liability was reviewed/considered.

We agree that determining exactly what the taxpayer is asserting in this case is a problem. Based on the Form 12153 and the Form 843, we construe the taxpayer's position to be that (1) the taxpayer should not have to pay the taxes at issue because [REDACTED] was contractually obligated to pay them, and (2) even if the taxpayer is liable for the taxes, the taxpayer has reasonable cause to have the penalties and interest abated. The taxpayer does not appear to be questioning the existence of the employment tax liability; rather, the taxpayer is arguing over who should pay it.

This is simply the CDP reflection of the taxpayer's original argument in the employment tax audit, which was that the taxpayer was not liable for the employment tax deficiency because the leased workers were employees of [REDACTED] and not employees of the taxpayer.

As noted above, a taxpayer in a CDP case may dispute the merits of the underlying tax liability only if the taxpayer "did not receive any statutory notice of deficiency for such tax liability or did not otherwise have an opportunity to dispute such tax liability." I.R.C. § 6330(c)(2)(B). In the present case, the taxpayer has made no claim that it did not receive the § 7436 Notice. Thus, the taxpayer had the opportunity to petition the classification issue to the Tax Court. The taxpayer chose not to do so. The right to petition the Tax Court was "an opportunity to dispute such tax liability" within the meaning of I.R.C. § 6330(c)(2)(b). In addition, the taxpayer may not challenge the conclusion (which necessarily follows from § 7436 Notice) that the taxpayer, and not [REDACTED], was the employer and is therefore liable for the employment taxes at issue in this case.

We reach a different conclusion with regard to the taxpayer's request for abatement of penalties and interest. [REDACTED], the Tax Court had taken the position that it did not have jurisdiction over the amount of tax owed in a case arising under I.R.C. § 7436. The fact that Congress later overruled this position of the Tax Court does not change the fact that, for CDP purposes, the taxpayer never received any kind of notice that would have permitted it to obtain Tax Court review of whether the amount of its liability should include interest or penalties. In addition, there is nothing in the file which indicates that the taxpayer ever had a previous opportunity to have this issue reviewed by Appeals. Therefore, we believe that Appeals does have jurisdiction to consider the taxpayer's request for abatement of interest and penalties in this CDP case. Of course, we express no opinion in this memorandum on the merits of the taxpayer's request. We conclude only that Appeals should consider it, and Appeals determination of this issue should be stated in the CDP notice of determination.

E. The Type of Notice of Determination Which Should Be Issued

As noted in the above discussion of I.R.C. §§ 6320(c) and 6330(d)(1), if a taxpayer disagrees with Appeals' determination in a CDP case, the determination may be appealed to the Tax Court.

¹The Tax Court filed its opinion in [REDACTED]
[REDACTED], supra, [REDACTED]

I.R.C. §§ 6320(c) and 6330(d)(1)(A). If the Tax Court "does not have jurisdiction of the underlying tax liability," the appeal lies to a United States District Court. I.R.C. §§ 6320(c) and 6330(d)(1)(B). If Appeals concludes that its determination in a CDP case relates to a type of tax over which the Tax Court has jurisdiction, it issues its notice of determination on a Letter 3163 which directs the recipient to file his petition in the Tax Court. If Appeals concludes that its determination in a CDP case relates to a type of tax over which the Tax Court does not have jurisdiction, it issues its notice of determination on a Letter 3164, which directs the recipient to file his petition in the appropriate district court. If Appeals concludes that its determination covers both types of taxes, it issues two separate notices of determination, one on a Letter 3163 for that part of the liability attributable to taxes over which the Tax Court has jurisdiction, and another on a Letter 3164 for that part of the liability attributable to taxes over which the Tax Court does not have jurisdiction.

The present case involves employment taxes, a type of tax over which the Tax Court does not ordinarily have jurisdiction. On the other hand, the principal issue in this case was determined under I.R.C. § 7436, which contains a special provision for Tax Court review. We believe that the specific statutory provisions contained in I.R.C. § 7436 control this case for CDP purposes, as opposed to the more general rule that the Tax Court does not have jurisdiction over employment taxes. Therefore, we conclude that in the present case, the Tax Court has "jurisdiction of the underlying tax liability" for purposes of I.R.C. § 6330(d)(1). Therefore, we recommend that the notice of determination in this case be issued using Letter 3163.


We are cognizant of the fact that we took the position above that the Tax Court could have considered only the classification issue, and not the amount of the tax liability, if the taxpayer had petitioned its § 7436 Notice to the Tax Court in 1999. We also noted that the amendment to I.R.C. § 7436, discussed above, came too late to have permitted the Tax Court to consider the amount of the tax liability if the § 7436 Notice had been petitioned in 1999. Upon these considerations we based our conclusion that, in the present CDP case, Appeals has jurisdiction over the taxpayer's claim for abatement of interest and penalties. However, in considering which court has jurisdiction over a CDP appeal, we believe that I.R.C. § 6330(d)(1) refers to the jurisdiction of the Tax Court as it exists when the CDP notice of determination is issued and not the jurisdiction of the Tax Court as it existed when the underlying tax liability was originally determined. All of the verbs in I.R.C. § 6330(d)(1) are in the present tense, not in the past tense. Since the amendment to I.R.C. § 7436 now gives the Tax

Court jurisdiction not only over the classification issue but also over the amount of the resulting tax liability, we think that, for CDP purposes, the Tax Court now has "jurisdiction of the underlying tax liability" in the present case.

If the taxpayer in this case does file a petition in the Tax Court, and if the Tax Court disagrees with our opinion as set forth in this memorandum and dismisses the taxpayer's CDP case for lack of jurisdiction, then the taxpayer will still have thirty days in which to refile his appeal in the district court. See I.R.C. § 6330(d)(1), flush language, quoted above.

Since nothing further remains to be done on this case, we are closing our file. If you have any questions, please contact the undersigned at (949) 360-2691.

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse affect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.


WILLIS B. DOUGLASS
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Attachments